ATTACHMENT II
PROPOSED SECTION 108 LOAN GUIDELINES

1. COLLATERALIZATION REQUIREMENTS

<u>Background</u>: HUD requires a pledge of collateral that is equal to at least 125% of the loan amount for all loans. This has changed since the mid 90's, when loans with a term of 10 years or less did not require collateral. It should be noted that collateral is required *in addition to* the pledge of future CDBG funds as security; as a result, HUD would turn to the collateral for repayment in the event of City default and the further event that the CDBG program had been eliminated by Congress or for some other reason was not available to cure the default. Collateral may be in the form of liens on real estate (either fee simple, leasehold interest) or on personal property; pledges of revenue from such sources as CDBG program income, tax increment gains, , debt service reserves, assignment of leasehold interest; or other city revenue streams. HUD has also recently suggested that leasehold interests in parkland, in the form of lease-leaseback arrangements, in certain circumstances, would be acceptable to them as collateral.
<u>Discussion</u>: The Manager has been implementing the HUD Section 108 loan program with a general understanding that the collateral pledged for each loan would be the loan related asset (land and improvements) and/or project related revenue such as tax increment revenue. However, there are now several 108 projects for which project related assets cannot be used or are not sufficient to meet HUD's collateral requirement. Assets that cannot be used include projects on land that is not owned by the City, those that are subject to lease or other funding restrictions, and most public improvements. In some cases, the Manager needs the asset being financed with the loan proceeds to collateralize other City financing efforts. The Manager therefore is seeking guidelines for the collateralization of these loans when the project itself cannot be used or is not sufficient. Attachment III lists 108 loans and pending loans and indicates how the proposed guidelines would apply to each. The Manager will be seeking Council authorization to encumber City assets for each of these loans after guidelines are established.

<u>Proposed Guidelines:</u>

(1). Whenever possible, the Manager will recommend to the Council that the loan related asset, including leasehold interests and/or any revenue generated by the loan related project be used to collateralize the loan.

(2). When full collateralization of a loan is not possible using only the loan related asset or revenue stream, the Manager will consider the following options in terms of each project's situation and needs and recommend that one or more of the following be used:

a. From within the same Council district only, alternative real estate, revenue, or other assets including, but not necessarily limited to:

- Other 108 loan financed real estate which has uncollateralized value

- Any other appropriate City property
- Tax increment revenue (applicable only to projects in redevelopment areas)
- Assignment of leasehold interests, including the assignment of rights related to lease-leaseback agreements on property that could not otherwise be used as collateral, parkland in particular

b. Granting HUD the right to attach the City's final CDBG entitlement grant in the event that Congress terminates the CDBG program.

3. Community and Economic Development staff will track collateral status for each loan and, in the case of those that are collateralized wholly or in part by alternatives contained in guideline #2, will take necessary steps to reduce the collateral to the loan related assets. These steps could include the release of encumbrances as loans are paid down and the substitution of one collateral source for another. HUD is generally receptive to substitution of collateral as long as the newly offered collateral still meets their 125% requirement.

NOTE: All future requests by the Manager for authorization to apply for a Section108 loan will identify the collateral options, make a recommendation regarding the pledge of assets to be used as collateral, and seek Council authorization to pledge such assets. Thus the Council will have an opportunity to review the proposed collateral arrangements before applications are submitted to HUD.

2. LIMITS ON HUD SECTION 108 DEBT

Background: HUD regulations limit the amount of 108 debt that a city can carry to 5 times its annual entitlement amount. The current limit for the City of San Diego is $93.5 million. This amount changes slightly from year to year. HUD regulations also stipulate that if loan guarantees are issued by HUD in any one year in an amount that equals 50% of the entitlement amount for that year (i.e. $9.35 million for San Diego this year), further restrictions may then be applied. These are the only restrictions placed by HUD on the amount of 108 debt a City can incur.
Discussion: As it is now clear that HUD requires collateral, steps should be taken to do so in a manner that best protects the City. The provision of collateral requires the mortgaging of City assets and risk of foreclosure, in the event, however unlikely, of default by the City and unavailability of CDBG funds. Our annual 108 debt payment is $3.5 million this fiscal year. With the addition of the loans already approved but not funded and all pending loans, the annual debt payment would increase to over $6 million. The City has traditionally maintained low debt

amounts. Section 108 loans have to be recorded in the City books as debt and treated as debt. If the CDBG program were to be eliminated at some future date, the City would have to find another revenue source to repay the loans or allow HUD to foreclose on the pledged collateral. The Manager has been advised by the City Auditor that if there is not a reasonable policy, and perhaps some limitation on the amount of 108 debt that the City can incur, the credit rating agencies might start counting this debt in our debt ratios, which has not previously been the case.

Proposed Guideline: Establish a limit on 108 debt to an amount no more than the 3.5 times the City's annual CDBG entitlement grant award. For this fiscal year, the debt ceiling would be $65.5 million. As mentioned in the accompanying Manager's Report and detailed in Attachment I, current Section 108 debt plus all pending debt totals $58.1 million.

3. ESTABLISHMENT OF AN ANNUAL APPLICATION PROCESS FOR 108 LOANS

Background: HUD accepts 108 loan applications at any time during the year and the Manager has always considered new loan requests as the need arises in relation to specific projects. The general status of our HUD 108 loan portfolio is presented to Council with each request for authorization to submit a loan application to HUD; however, there is no formal mechanism for providing status information to the Council or for the Council to review the use of 108 funds in a comprehensive manner.

Discussion: The Manager believes that having an annual process for the submission of projects to be assisted with HUD 108 loan funds and for review of the 108 portfolio would afford both staff and the Council a means to enhance their review of proposed projects and to better manage the HUD 108 program. The annual Consolidated Plan process, which generally occurs between January and April, and is intended to be the planning process for the use of CDBG and related HUD funds, would provide an appropriate vehicle for annual 108 policy discussion and review.

Proposed Guideline: The Manager will utilize the annual Consolidated Plan process to provide a status report regarding use of Section 108 funds to the City Council. In addition, to the greatest extent possible, the Consolidated Plan process will be used to structure the consideration of projects to be assisted with 108 loan funds. This would require that a list of projects to be considered for 108 financing during the following year be submitted to the Manager prior to the Consolidated Plan public hearing process. These projects could then become part of the Consolidated Plan which is submitted to Council for review, usually in May of each year. The Council would subsequently have an opportunity to review the proposed projects, consider the merits and public benefit of each, assess the impact on the City's overall debt as well as on the CDBG program, and decide whether or not to utilize the City's 108 borrowing capacity to assist these projects.